

SUMMARY

The Bulgarian Economy, 2007 Q1

- Gradual slow down in economic growth is coming up. There may be some short-term acceleration in 2008 and 2009 depending on efficient and well-targeted absorption of EU funds.
- Heading into 2007 with a record-breaking value, in Q1 the ESTAT index of business climate scarcely moved up. While its April value is the highest ever in the history of the index, it is only 23 percentage points up on January value. Obviously, the EU membership euphoria has proved a short-lived phenomenon and business attitudes quickly move back to the normal course of daily routine issues.
- 2006 economic growth is attributable to growth in employment rather than growth in productivity.
- Total economic growth for 2007 Q1 is estimated at about 5.7-5.9 per cent, with annual levels projected at about 6 per cent.
- Having been broken in 2006, the tendency of higher growth in imports against growth in exports was restored in early 2007.
- In the first two months of 2007 the current account deficit moved up to 3.4 percent of annual GDP. Foreign direct investments cover only 40 per cent of the deficit but as the statistical measurement methodology has been changed the data cannot be used to draw up permanent conclusions. 2007 current account deficit is not expected to exceed 18 per cent of GDP and most, although not all, of it will be covered by foreign direct investments. In 2008 and 2009 the current account deficit will remain at levels close to 2007 ones.
- Inflation is decreasing on an annual basis, down from 7.1 in January 2007 to 4.1 per cent in March against March 2006, with higher prices in the group of non-food goods being most contributive of total increase in the prices of consumer goods and services.
- Short-term proinflationary anticipations of the population, associated with country's EU accession, did not come true. Serious adjustments of administratively regulated prices are not expected and therefore total accumulated inflation for 2007 will not exceed 4.5 per cent, continuing on a downward trend in 2008 and 2009.
- Despite the avalanche-like growth in private foreign debt, financial stability is not threatened in a short-term perspective. In a long-term perspective it is depended by maintained inflow of foreign investments and increased economic competitiveness through stepping up structural reforms, liberalized business environment, privatization, rehabilitated education system, etc. – areas which currently register stagnation.
- Unemployment continues on a downward trend, however at a slower pace. Employment of the economically active population registers higher growth.
- No progress is registered in the reform and improvement of the quality and efficiency of the healthcare system.
- Consolidation in the banking sector continues and the sector remains stable. Growth in consumer loans decreases and leasing strengthens its position as one of the top-yielding and rapidly developing financial sectors.
- After the euphoria at BSE-Sofia in early 2007 and persistent peak values of indexes, a logical correction followed in March. The broader index BG40 restored and even went above its pre-slump levels, whereas SOFIX fails as

yet to climb up to its peak values. Prospects for the Bulgarian capital market are significant.

- In a sectoral aspect, accelerated growth in the value added of industry persists whereas deteriorated railway transport and lower growth in tourism against the same period of last year are raising concerns.

Macroeconomic Dynamics

↔
GDP
growth

In 2006, Bulgarian economic growth was slightly lower (real GDP growth of 6.1 per cent) compared to growth in 2005. (6.2 per cent). Focal points of **total economic growth** formation in 2006 against a year back include **accelerated growth in value-added of industry** (up 8.3 per cent against 4.7 per cent in 2005) and **delayed growth in investments** (down to 17.6 per cent against 23.3 per cent in 2005). NSI's revised data for the period 2002–2006 show that 2004 is the peak year for economic growth (6.6 per cent). **We expect total economic growth in 2007 Q1 to accelerate to about 5.7–5.9 per cent and annual growth to stand at about 6 per cent** (against 5.5 per cent in Q1 of last year and 6.1 per cent annually for 2006)¹. The tendency of smooth slowdown in economic growth will persist, with possible short-term acceleration in 2008 and 2009 in the issue of EU funds absorption (by + 0.1 – 0.2 percentage points).

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high values
of business
climate
indicator

The high economic activity registered at the end of 2006 persists in the first months of 2007. Till March 2007 **the general business climate in the economy indicator** remains at levels by 30 percentage points above its long-term value. **The record-breaking indicator values** registered in NSI's business surveys since mid-2006 not only persist in industry and construction but improve in trade and services. Expectations for relatively stable dynamics of economic growth in 2007 are supported also by the fact **that in all four monitored industry sectors the business climate values are notably higher against early 2006 values**. Interesting is the new fact that in the business surveys shortage of labor is emerging as a problem for the business in industry and construction.

Consumer confidence remains conservative compared to business attitudes. Town people are more optimistic in their expectations compared to households in villages.

↓
delayed
growth in
industry

Short-term **industry** statistics for the first two months of 2007 confirms the trend of **delayed economic growth** observed since October 2006. More significant is the slowdown in sales which in February increased by only 3.5 per cent on a year-over-year basis, against 15 per cent in last February, and production increased by 6 per cent against 9 percent in February a year back. Delayed growth in export sales is more significant compared to that in domestic sales. However, the industrial capacity load indicator remains at relatively high values and corresponds to business anticipations of preserved production activity.

Value added registers accelerated growth in 2006 (by 6.0 per cent against 5.3 per cent in 2005) contrary to the slight slowdown of GDP growth (down from 6.2 per cent in 2005 to 6.1 per cent). On the **supply side**, *the industry sector* is operating at the highest and accelerating pace in 2006 and the value added generated by this sector is up 8.3 percent, or almost twice the growth in 2005 (4.7 per cent). *Services* remain more contributive of GDP growth in 2006 on the production side, although value added growth in the sector has slowed down (to 6.1 per cent on an annual basis against 8.3 per cent in 2005). In 2006 *the*

¹ To compare, latest reports by AEAf and BNB do not attempt at estimates of real GDP growth in 2007. (Source: AEAf, Bulgarian Economy: Condition and Perspectives, Bulgarian Economy in 2006, annual report; BNB, Economic Review, 1/2007). In a more general perspective both institutions expect high economic growth to persist in 2007 and to accelerate in the years to come.

agrarian sector again failed to break the downward trend, but decrease in value added slowed down to 2.9 per cent against 9.5 per cent in 2005.

On the **demand** side of the economy, 2006 GDP growth of 6.1 per cent is formed by a contribution of 12.3 percentage points of internal demand and a negative contribution of 6.2 percentage points of foreign trade in goods and services. **Higher contribution have final consumption** (up from 4.6 percentage points in 2005 to 5.7 percentage points) and dynamics in stocks (up from 1 to 2.4 percentage points respectively). **Contribution of investments in equity decreases** (from 4.8 to 4.2 percentage points). Growth in the contribution of exports (from 4.8 to 5.4 percentage points) remains slower than growth in the negative contribution of imports (up from 9 to 11.6 percentage points).

higher
negative
balance of
trade



Consumption remains most contributive of total economic growth on the demand side. In 2006 its real growth is higher compared to previous year (6.5 and 5.3 per cent). Contrary to 2005, however, in 2006 final consumption has higher contribution in GDP growth compared to exports of goods and services which register almost negligible growth (from 8.5 to 9 per cent). At the same time, with a lower contribution of *investments*, higher contribution of final consumption is offset by higher negative contribution of imports of goods and services which register accelerated growth by two percentage points (from 13.1 to 15.2 per cent). **Thus the negative balance of trade in goods and services increases from 16.2 per cent in 2005 to 19 per cent of GDP in 2006.** In 2006 investments in equity dynamics registers again highest values on the demand side showing however delayed growth (from 23.3 per cent in 2005 to 17.6 per cent in 2006).

higher
current
account
deficit



In 2006,² the **current account deficit** is up 52 **per cent** on 2005, at EUR 3 378 m. **The current account deficit ratio to annual GDP amount is up 15.8 per cent, deteriorating by 3.8 percentage points against 2005.** Notable for 2006 is the fact that the relative deterioration of the trade balance (by -1.3 percentage points) has significantly lower unfavourable effect on current account's relative deterioration (which is -3.8 percentage points) compared to 2005 (-5.3 and -5.4 percentage points respectively). The other 2.5 percentage points in the relative deterioration of the current account are attributable to deteriorated balance of transfers (-1.1 percentage points), services (-0.8 percentage points) and incomes (-0.5 percentage points).



growth
in exports

delayed
growth in
revenues
from
tourism



In structural terms, the higher **trade deficit** in 2006 is mostly attributable to **growth in the imports of energy products (mainly crude oil) and investment goods (machines, transport vehicles and apparatuses).** The **shrinking negative contribution of foreign trade balance in the current account deficit is attributable to accelerated growth in exports (from 18.6 per cent in 2005 to 26.6 per cent in 2006) and delayed growth in imports (from 26.9 to 25.2 per cent respectively).** Growth in exports is higher than growth in imports. The deteriorated positive balance in *services* is mostly attributable to deteriorated positive balance in the item Travels. **Growth in revenues from tourist services has slowed down to 5.4 percent in 2006 against 9.3 percent in 2005.** The positive balance of transport services deteriorates and so does the negative balance of the item Other Services. The positive balance of the item Incomes is on a downward trend attributable to a fast growth in investment income payments.

In line with the anticipations of continuing high inflow of foreign direct investments in the country, we can expect growth in corresponding transfers abroad of income from such investments to persist. Net inflow of *current transfers* is down 20 per cent compared to the previous year when it was by 10 per cent higher on a year over year basis.

² Source: BNB, Balance of Payments, published on 13 April 2007. Ratios are calculated taking the 2006 gross domestic product (NSI's preliminary estimates) of EUR 25 099.6 m and a 2007 estimate of EUR 26 724 m.

current
transfers



trade with
EU



Changes in the accounting method for trade with EU Member States account for some uncertainty as to the correctness of **foreign trade** preliminary estimates for 2007. Despite that, the high degree of **integration** of the Bulgarian economy with the European market remains a characteristic feature of Bulgarian foreign trade. In the first two months of 2007 this market accounts for 67 per cent of exports of products and for half of imports. This is attributable not only to Romania's integration into this market but also to the real opening of borders. The increasing European focus of trade is supported also by the fact that in 2007 exports to non-EU countries is down almost 5 per cent and imports – 22 per cent.

In 2006, foreign direct investments to Bulgaria exceed EUR 4.1 b and cover the current account deficit at 103.2 per cent.

In the first two months of 2007 the current account deficit increases to 3.4 per cent of GDP estimates against 2.6 per cent for the same period of 2006. Despite that, we can expect that it would not exceed 18 per cent till year end. The deteriorated current account deficit **with EUR 262.3 m** is formed by growth in the balance of trade deficit of EUR **300.1 m** and improved balance of services and incomes. Based on available data for 2007, nominal growth in the exports of goods is only 4.1 per cent on an annual basis against 31.7 per cent in the first two months of 2006. Lower compared to a year back is also growth in imports (fob) registered so far (15.9 per cent against 33.6 per cent for the first two months of 2006), but in terms of imports the difference in growth is not so striking. In the first two months of 2007, the balance of incomes is positive and improves on a year over year basis, which is attributable to higher inflow to the item "Compensation of Employed Persons". Net proceeds from current transfers are negligibly above the level for the same period of 2006. **In that period, the inflow of foreign direct investments to Bulgaria has decreased compared to a year back (from EUR 496 m to EUR 380 m). Thus foreign direct investments cover only 41.6 per cent of reported so far current account deficit for the first two months of 2007, against 76.3 per cent for the same period of last year.** Data are too tentative and, due to methodological changes, rough, to provide a basis for permanent conclusions.

inflation
decreases



In the first three months of 2007 **consumer prices** increased by 1.8 per cent (against the last month of 2006), with slight deflation registered in March against February (-0.1 per cent). **Inflation decreases on a year over year basis**, down from 7.1 per cent in January to 4.1 in March against March of last year. Most contributive of total increase of prices of consumer goods and services till March are the higher prices in the group of food goods (up 2.3 per cent against December 2006). Administratively regulated prices have increased by 2 per cent since the beginning of 2007. Accumulated in the first three months of 2007 total increase in *the prices of specially monitored goods and services*³ is 2.7 per cent, measured by the national consumer price index for the big basket (1.8 per cent). Since the beginning of 2007, increase in the prices of foods goods included in the small basket is up 3.4 per cent on the increase in the prices of foods included in the big basket (2.3 per cent).

In the first two months of 2007 the dynamics of **producer prices in industry** is slow. In January total producer prices (export and domestic market) decreased by 1 per cent, and in February they increased by 0.1 per cent. In January, domestic market producer prices decreased by 0.78 per cent and increased in February by negligible 0.06 per cent.

NSI's business surveys for the first three months of 2007 do not indicate any short-term inflationary pressure. On the other hand, consumer surveys (January 2007) still register inflationary expectations of households for the next 12 months.

³ This is the so-called small consumer basket of 100 specially chosen goods and services, weighted with the expenditures of the 20 per cent of the lowest income households. The 2006 big consumer basket contains 531 goods and services.

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Increased
economic
activity of the
population

High economic growth in 2006 is accompanied by **significantly increased economic activity of the population nationally**, which is associated with accelerated growth in the number of employed and more moderate decrease in the number of unemployed persons. In 2006 employment increased at a twice higher pace compared to previous year – the number of employed persons in the economy is up 4.3 per cent against 2 per cent in 2005. The number of unemployed persons decreased by 8.6 per cent and at a higher pace compared to the number of employed persons, but has slowed down compared to decrease in unemployed persons in 2005 (16.4 per cent). The lower number of persons outside the labor force (down by 115 thousand against no change in 2005) and of discouraged persons⁴ (down 74 thousand against 48 thousand in 2005) indicates that the economy has managed to generate jobs for people who for some time have been off the labour market.

GDP growth
is mostly
attributable
to growth in
employment
↓

Over a year, the structure of employment has registered notable changes towards lower number and share of employers, self-employed and unpaid employed persons with parallel significant increase in the number and share of employees, up from 85.6 to 87.3 per cent.

Productivity. In 2006, growth in productivity is lower than growth in employment and has slowed down compared to previous years. **2006 economic growth, which is 6.1 per cent, is rather attributable to growth in employment (up 4.3 per cent) than to growth in productivity⁵ (1.7 per cent)**, contrary to 2005 when total economic growth (6.2 per cent) was attributable to higher growth in employment (4.1 per cent) compared to growth in productivity (2 per cent).

↑
unemployment
decreases

Unemployment. Unemployment continues **on a downward trend**, but at a slower pace. Slower decrease in the number of unemployed persons on an annual basis (down 8.6 per cent in 2006 against decrease of 16.4 per cent in 2005) indicates that the potential of matching the labour supply by unemployed persons and the labour demand in the economy is somewhat exhausted. Unemployment coefficients continue downwards. **Total unemployment is down from 10.1 per cent in 2005 to 9 per cent in 2006**, the permanent unemployment coefficient (share of permanent unemployed person in the economically active population) is down from 6 to 4.7 per cent of the economically active persons aged 15+. Unemployment of young people between 15 and 24 years also decreases from 22.3 to 19.5 per cent.

ESTAT Index of Business Climate

↑
Improved
condition of
enterprises

Heading into 2007 with a record-breaking value contrary to tradition, in Q1 the ESTAT index of business climate scarcely moved up. We have not witnessed the April jump in index values observed in the past four years. Data show that problems of transition have given place to issues typical for steady developing market economies.

The ESTAT index value registered in April is attributable to a latest, although rather small, improvement in the condition of companies. However, it is accompanied by some deterioration in investment attitudes which have reached unprecedented high values in the first month of the year. Moderateness in terms of investments has, for the first time in index's life, made the index totally unsusceptible to seasonal regularities. It seems however that we are entering a period of permanent break of traditions, having in mind that in the previous study we registered utterly unusual autumn-winter improvement of index values. At the same time, the State Component, which measures the condition of the legal, political

⁴ These are people who want to work but are not active in looking for jobs and therefore belong to the “persons outside the labor force” group and not to the labor force.

⁵ Measured by the gross domestic product per employed person.

and administrative framework, remains at the levels registered in the past two surveys, or negative 15–16 points.

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number of
companies
implementing
business
strategies
increases

The ratio of prospering to “drowning” companies remains at normal values, with slight seasonal “bonus”. The share of companies in good condition, whose managers project persisting positive trend in the next quarter, has moved up by 1 per cent against January and the number of companies in poor condition, whose managers project aggravating problems, has decreased by exactly the same percentage. Data show that overall condition of companies in Bulgaria is stable and improving.

The share of companies, whose management has developed and implements business strategies, has significantly increased.

For the first time since April 2002 the share of managers ready to take investment loans has again moved above the two-thirds margin. **One can say that following notable deterioration in the period 2003–2005, now investment finance seems absolutely “vindicated”.** This is probably attributable to the large number of adequate products and more beneficial interest levels and guarantees.

serious
human
resource
problems

Human resource problems have become a sore point. Following certain “remission” in late 2005 and early 2006, the situation is aggravating with every quarter. The present survey established a new negative record. Now less than one-third of respondents say that they can easily find the workers and employees they need. Previous record-low value was by 1.5 percentage points higher.

Economic policy

Enterprise policy. Full EU membership is accompanied by changes in the business environment, the requirements and the opportunities opened up to the Bulgarian business. **Entrepreneurs will be able to receive support from the operational programs for absorption of the EU Structural Funds and Cohesion Fund.** Targeted at the business is the program “Development of the Competitiveness of the Bulgarian Economy” with allocated over EUR 1 b for the period till 2013. Allocations for business support will be made under other programs as well. The main challenge for entrepreneurs is to develop quality projects, which are well-grounded and correspond to the major priorities under operational programs.

EU accession will also open up new opportunities for innovative development of Bulgarian enterprises. The Seventh Framework Program for Research and Technological Development of the EU was launched in early 2007, with a budget of EUR 54.4 b, or up 60% compared to previous programs. The program is very important for Bulgaria as it opens up new opportunities – Bulgarian scientists and researches will be able to participate not as external partners but as people from the EU.

Bulgaria’s accession to the EU has brought about changes in the trade policy – **more than half of trade actually remains outside customs control.** This has further facilitated trade, but at the same time new requirements create a lot of problems for companies as well as for institutions. There is a need to quickly get over the points in the new requirements and rules that are not clear to the business.

Efforts to improve the business environment and the administrative service of Bulgarian entrepreneurs continue. **Unfortunately in many fields (regulatory regimes, fight against corruption) these remain at the level of good intentions.**

After Bulgaria’s accession to the EU, **government efforts to achieve progress in the restructuring of state monopolies, market liberalization, and to complete the privatization process have also failed to produce any results.**

poor
performance
in fight against
corruption

VAT
collection rate
↓
↑
corporate tax
collection
rate

Public finance. In consequence of contributions to the European budget, in the first two months of 2007 the consolidated budget of the country shows **deficit** of some BGN 20 m. After our joining the EU, **the value-added tax** remains the most significant source of budget revenues, despite some problems with its collection after the accession. At end of February 2007, **excise duty** amount registers growth against the same period of **2006**, which is attributable to higher rates, wider scope of goods and the fact that imports of excise goods do not come mainly from the EU. **Corporate tax** registers higher absolute amount, which is attributable to lower rates and economic growth. Despite the avalanche-like growth in private foreign debt, **financial stability is not threatened in a short-term perspective**. In a long-term perspective Bulgaria's financial stability is depended by stepped-up structural reforms, liberalized business environment, privatization, rehabilitated education system, etc.

promised lower
social security
contributions
doubtful
↓

Social and health policy. In early 2007, the Government approved National Reform Program, 2007-2009, which sets out targets of sustained economic growth of 6 per cent and employment level of 61 per cent at end of period. In 2007, unemployment is to decrease to 8.6 per cent and go down to 8 per cent in 2009. **European Commission's recommendations to the program are for lower relative share of budget expenditures in the social sphere, in particular in healthcare.** Despite that, in the first quarter of 2007 income policy does not demonstrate a restrictive approach, and **some proposals of the social ministry for indexation of pensions and salaries create potential risk as to maintaining the planned budget surplus.**

Execution of budget revenues in the first quarter does not give grounds to implement the promised decrease of the social security burden by another 3 percentage points at mid-2007. Social security policy priorities are refocused from business to the fisc. The discussion, provoked by a representative survey of the grey economy and data showing that employed persons fail to declare one-third of their income, produced proposals for more severe sanctions and budget co-financing of social security.

problems in
healthcare
increase
↓

Healthcare still gives rise to the most urgent social policy problems. The regulatory mechanisms introduced in 2007 aggravated contradictions between medical care providers and the National Health Insurance Fund. The government prepared the latest new variant of a National Health Insurance Strategy but failed to propose significant changes in the method of funding and paying for healthcare services. Major parameters of the strategy include privatization of medical institutions, limiting the functions of the professional and branch organizations and extending the rights of patients.

poor
performance
in waste
management
↓

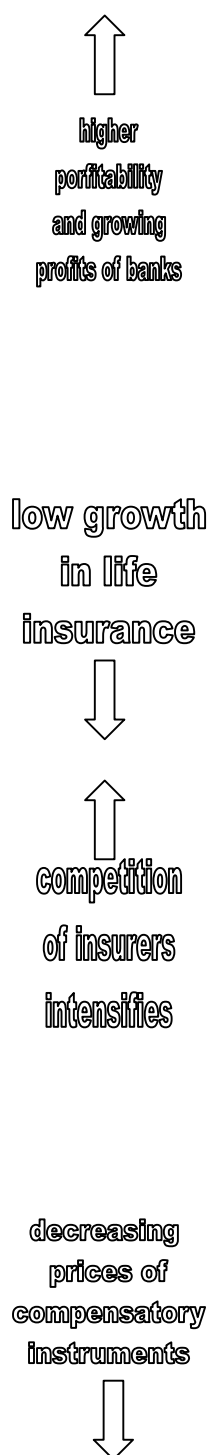
Environmental policy. **The impact of government environmental policy on economic activity is still more of an administrative and restrictive nature and its performance is rather poor**, considering the sustainable management of natural resources and improvement of the general condition of the living environment. Adoption of National Allocation Plans for greenhouse gas emission allowances trading for 2007 and 2008-2009 is a step forward in the area of climate change and the fight against global warming. The results of the green emissions trading scheme will only be felt at year end when EC will approve National Plans and the electronic register of emission quotas will become operational. Until that time the procedures of obtaining emission trading permits will remain one more administrative burden for Bulgarian enterprises.

For a second year the Ministry of Environment and Waters reports unsatisfactory performance in waste management. Participation in collective organizations or in the state enterprise by payment of product charges has strengthened its position as a major scheme for fulfillment of waste utilization targets. In both cases, however, the ultimate result is a serious problem with the quantities of untreated waste – an issue which, in the long run, is left to local authorities to decide, with unclear responsibilities of the state. The

financing which is expected to come from the European funds under Operational Program “Environment” opens up opportunities to largely solve the problems concerned with the building up of a modern national environmental infrastructure.

Government’s decisions of early 2007 on the inclusion of national territories in the European environmental network Natura 2000 prejudice a major Bulgarian advantage lying in the rich biodiversity and the associated specific advantages in the areas of tourism and agriculture. On the other hand, **delaying the final decision on the size of protected areas, to the benefit of investors’ interests in construction**, makes uncertain implementation in the near future of the integrated territories management approach – a long-term goal of the European environmental policy.

Financial Sector



Banking sector. Growth in broad money is fast but has slowed down. Deposit base continues upwards. This is attributable to growth in the disposable income of households and companies, as well as to the large number of Bulgarians working abroad. Lending remains the biggest source of income in the sector. The level of “bad debts” is comparable to that of EU countries. Launched implementation of Basel Regulations did not have negative impact on financial performance. **Profits and profitability increase. Banks have stronger influence on the capital market.** Income from stock exchange operations and asset management will be significant for sector’s future profitability. Competition in the sector will increase with the entry of new actors and ongoing consolidation.

Insurance sector. According to preliminary estimates, slow down of growth in life insurance persists. 2006 growth in this sector is projected at 27 per cent, which is significantly lower compared to the growth of 50 per cent in 2005.

The notification regime for the registration of foreign insurance companies, which intend to operate on the territory of Bulgaria, took effect since 1 January 2007. With the free provision of insurance services, **all preconditions are now in place for a competitive insurance environment** with a favorable impact on insurance market development. In the first four months the Bulgarian insurance market enjoys top interest – 78 companies have filed applications. They will offer mainly general insurance products.

Bulgaria has signed the Green Card agreement and thus the regime for free movement of cars in the European Union is expected to take effect about mid-2007. Despite that, it is still not clear whether Bulgaria’s control authorities will be able to maintain the wide scope of the Third Party Liability Insurance. For the time being, operation of the scope reporting mechanism is not reliable.

The tendency of entry of new foreign players on the Bulgarian market through acquisition of Bulgarian companies, and of sector consolidation persists in early 2007. Strategic consolidation of insurance and banking companies will also go on. The biggest event in the sector was the sale of the market share leader DZI AD and its subsidiaries to Belgian insurer KBC Group NV.

Capital market. **After the euphoria at BSE-Sofia in early 2007 and persistent peak values of indexes, a logical correction followed in March.** The broader index BG40 restored and even went above its pre-slump levels, whereas SOFIX fails as yet to climb up to its peak values. Debates on SOFIX composition continue, brought about by lack of clear rules for the selection of companies in the index composition.

Contrary to shares, compensatory instruments continue steady downwards as their future is not clear.

Hot discussions on tightening of the COBOS trade regime are going on since early 2007. They aim to limit market manipulation opportunities, while not bringing about a ban on the electronic placing of orders on the Internet.

↑
Interest towards
the privatization
of 44 per cent
of BSE-Sofia

Banks have stronger influence on the capital market. Deposits in contractual funds increase.

By end of May the government is expected to approve a strategy for the sale of its 44 per cent share in the capital of BSE – Sofia. To date, seven foreign exchanges and groups have shown interest towards the state share in Bulgarian Stock Exchange and/or cooperation. These include Deutsche Börse, the Scandinavian OMX, the Greek operator Hellenic Exchanges, the Vienna Stock Exchange, Borsa Italiana, the Czech stock exchange and the Warsaw Stock Exchange. The government should approve a strategy with criteria enabling a fair tender. On the other hand, the sale should aim not so much at financial profit for the state in a short-term perspective, but at finding an experienced strategic partner for the Bulgarian capital market, with the necessary know-how and additional investment potential.

Main Economic Sectors

low
energy
efficiency
↓

Energy sector. Unusually warm weather in the first three months of 2007 brought about lower generation of electricity and thermal energy compared to Q1 of 2006. Electricity savings helped to keep stable the national power system after the shut down of units 3 and 4 of Kozloduy NPP. In the beginning of 2007 the government sought renegotiation of the decommissioning conditions for the two smaller units. The only opportunity for Bulgarian electricity consumers to gain some benefit lies rather in the targeted use of negotiated funds to improve national energy efficiency. This holds significant energy saving potential and is more profitable than even the cheapest energy generation. **Bulgaria lags behind in implementing energy efficiency measures in industry as well as in households.** Thermal power plants gained in significance after the shut down of units 3 and 4 of Kozloduy NPP. Varna TPP has announced intentions to increase electricity generation by 34 per cent in 2007. Construction of a new 700-megawatt capacity in Maritza Iztok enjoys strong investors' interest. In early 2007 the European Commission proposed a new common energy policy aimed to lower Union's dependence on external energy supplies and limit energy sector harmful emissions to the air. By 2020 energy from RES should account for 20 per cent of gross energy consumption. Within the negotiations for accession to the EU Bulgaria undertook a commitment to achieve 11 per cent share of RES by 2010. In 2006 this share stands at 1 per cent and excludes generation by water power plants. Lack of government support for the implementation of RES projects makes it impossible to fulfill undertaken commitments by 2010 and to achieve common European policy targets by 2020.

shortage
of freight cars
in BDZ
↓

Transport. A major issue of great importance to national transport companies is the introduction of licenses for cargo carriage to Turkey. The two countries have failed to agree on a carriage liberalization agreement. **If permits for transit via Turkey to third countries are introduced, most of the smaller carriers may lose their markets.** On one hand, they will have administrative barriers in the East and additional costs to overcome them. On the other hand, in the EU Bulgarian carriers are faced with the strong competition of big transport companies which have advance equipment and realize economies of scale. **There is still shortage of freight cars in the railway sector, which creates serious problems for the business.** In 2006 BDZ carried total 21.3 m tons of cargo, operating at the breaking point of its capacity. 2007 orders are expected to total at least 24 m tons of cargo, which means that Bulgarian business will have to pay the higher price for road carriage of at least 3 m tons of cargo. **There is urgent need of rehabilitation measures,** with priority focus on procuring of adequate number of acceptable freight cars by the carrier and enhancing section speed through railroad rehabilitation by the infrastructure company. As the new summer tourist season gets closer, three new low-cost air companies enter the Bulgarian market. Entry of low-cost carriers increases the competitive pressure on

the market. 2007 growth in the number of passengers transported by low-cost air companies is projected at 15 per cent.

↑
record-breaking
level of FDI
in construction
and real
estate

Construction and real estate. At the end of 2006 construction was again **on an upward trend**. According to preliminary estimates for 2006, the value added generated in the sector is up 9.9 per cent on 2005. Intensified activity represents a favorable trend against the slowdown registered in Q3 of 2006. Year-end acceleration is attributable to the large volume of foreign direct investments in the sector and to started implementation of big infrastructure projects. **In 2006, foreign direct investments in construction and real estate ran up to the all-time high EUR 1.8 b, accounting for almost one-third of total investments.** The focus is increasingly on greenfield investments.

The first months of Bulgaria's EU membership had a favorable impact on business attitudes in construction, shows NSI's business survey. Entrepreneurs are strongly optimistic about sector's condition in the next six months. Favorable trends like drop in delayed payments and higher demand are coming up.

↑
facilitated
mortgage
lending

Q4 of 2004 witnessed a boom of building permits for new residential construction. NSI reports slight increase in estate prices over the period, up 5.5 per cent on the previous quarter. Overall, entrepreneurs in the sector do not expect another notable rise of property prices.

Amendments to the Law on Obligations and Contracts are under way, aimed to facilitate mortgage lending. They include possibility to mortgage unfinished construction and to take more than one loan on a mortgage. The latter will result in lower administrative costs for the bank and the borrower.

↓
poor innovation
performance
of Bulgarian
companies

High technologies. In early 2007 Eurostat announced some unfavorable facts about Bulgaria's innovation performance, which have practical effect on the Bulgarian reality. **Only 16 per cent of companies are engaged in some form of innovation activity, which positions us behind all developed European countries.** Of course, this has a negative impact on stepping up of economic development. On the other hand, the ICT market is expected to register growth in the next years, which will contribute to some degree to improved performance of Bulgarian companies on international markets.

The government has presented two new initiatives – **National Innovation center for Information and Communication Technology** and **Draft Program for Stepping up Information Society Development**, which will have a positive impact on ICT sector development.

↓
excessive
construction
in tourism
goes on

Tourism. In 2006, the number of foreign tourists and revenues from international tourism continue upwards but at a slower pace compared to previous years. In 2007, number of foreign tourists is expected to increase by about 8 per cent. However, some tourist agency representatives are more pessimistic and project notably lower growth. This is mostly attributable **to overbuilding in big Black Sea resorts which puts off foreign guests.** Outflow of German tourists is expected to persist. Visas for people from non-EU countries (Macedonia, Serbia, Turkey) may well result in lower number of visitors from these countries.

Bulgaria is still among the cheapest tourist destinations in Europe (in particular for organized tourists). This is confirmed also by World Economic Forum's special Travel and Tourism Competitiveness Report published in early 2007. Bulgaria remains a cheaper holiday destination compared to its main rivals (Turkey, Greece and Croatia).

Prospects for development of special forms of tourism are improving. Projects in this field will receive support from European funds, in particular within OP Regional Development.

Problems in the tourism sector persist and some aggravate: overbuilding, outflow of qualified labor from the country, absence of national tourism development strategy, lack of adequate advertising strategy.

↑
opportunities
provided by
EU's Common
Agricultural
Policy

↓
delayed
building up
of Paying
Agency

Agriculture. 2007 is a transitional year for Bulgarian agriculture **as country's accession to the EU creates utterly new conditions and opens up new opportunities.** A major threat for sector's development lies in the large number of subjects whom the information about the compulsory regulations of the Common Agricultural Policy and possible preferences has to reach. Bulgarian agriculture competitiveness on the single European market will be depended by correct interpretation of these conditions and by producers' and administrative structures' preparedness to take advantage of the opportunity to participate in Common European Policy measures. **Almost the full scope of Common Agricultural Policy regulations are introduced for the first time,** with parallel operation of some previous support schemes. Total financial resource allocated to registered agricultural producers will come from the single area payment scheme, national budget programs, measures under the rural development and market intervention programs. Direct payments total close to BGN 500 m – enormous resource for a country of Bulgaria's size, which has to be properly channeled and the necessary institutional network for its absorption needs to be developed. **Delay in building up of the Paying Agency** and procurement of the necessary administrative capacity, in its registration by the European Commission and assessment of agricultural parcels identification faces the sector with the risk of receiving 25 percent less of the allocated annual direct farm payments. In that light, efforts in the sector will focus on the main goal to create conditions for maximum absorption of allocated resources from European funds.

EU Structural Funds and Regional Policy

In early 2007 the Bulgarian government presented the package of programming strategic documents (NRDS and 7 OPs) to EC in Brussels. Documents have been formally accepted and now Commission experts are making detailed review of their contents. Programming strategic documents are pending approval by end of summer.

The managing authorities for the operational programs have been designated; identification of intermediate program bodies to be entrusted with project selection and evaluation is going on.

In principle, the project tendering procedure can be launched after the operational programs are approved by EC. It is possible, however, to start tender procedures early (before approval of the strategic programming documents), to save time. The period is crucial for preparing project proposals ready to be submitted to OP's intermediate bodies for selection of the best proposals for support from the European funds.

Many Bulgarian municipalities are now prepared to apply with projects for financing from the structural funds. However, project quality needs to be significantly improved – mainly with respect to justification of project relevance to main OP priorities and presentation of more accurate financial estimates of project implementation costs.

A large information campaign organized by the Ministry of Finance was launched in early April with the aim to present the strategic programming documents for drawing money from EU funds.